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In the Supreme Court of the United States

OCTOBER TERM, 1958

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE PETITIONER

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OPINIONS BELOW

The opinion of the Court of Appeals is reported at 257 F. 2d 201 (R. 885–891). The opinion of the District Court (R. 82) is reported at 155 F. Supp. 521.

JURISDICTION

The judgment of the Court of Appeals was entered on May 22, 1958 (R. 892). The jurisdiction of this Court rests upon 28 U. S. C. 1254 (1) which is made applicable by Section 22 (a) of the Securities Act of 1933 (15 U. S. C. 77v (a)) and Section 44 of the Investment Company Act of 1940 (15 U. S. C. 80a–43). The petition for a writ of certiorari was granted Oc-

tober 13, 1958, and the case was consolidated with No. 237.

QUESTIONS PRESENTED

1. Whether a company which sells to the public its "deferred variable annuity policies," contracts under which the purchaser receives a pro rata interest in the company's portfolio of securities and in the gains and losses therefrom, is required (a) to register those contracts pursuant to the Securities Act of 1933 and (b) to register as an investment company pursuant to the Investment Company Act of 1940, or whether exemptions in these Acts relating to annuities and to companies engaged in the business of writing insurance are available to the company.

2. Assuming such a company would otherwise be required to file a registration statement for its contracts under the Securities Act of 1933 and to register as an investment company under the Investment Company Act of 1940, whether an exemption from those Acts is provided by the McCarran-Ferguson Act of 1945.

STATUTES INVOLVED

The relevant statutory provisions of the Securities Act of 1933 (15 U. S. C. 77a), the Investment Company Act of 1940 (15 U. S. C. 80a–1), and the McCarran-Ferguson Insurance Regulation Act (15 U. S. C. 1011) are set forth in Appendix A, *infra*, pp. 63–69.

STATEMENT

This action was instituted in 1956 by the Securities and Exchange Commission to enjoin the Variable Annuity Life Insurance Company of America ("VALIC")

from (a) offering and selling securities in violation of the registration requirements of Section 5 of the Securities Act of 1933 (15 U. S. C. 77e), and from (b) engaging in enumerated activities prohibited by Section 7 of the Investment Company Act of 1940 (15 U. S. C. 80a–7) until registered as an investment company under Section 8 of that Act (15 U. S. C. 80a–8). R. 3–10. The Equity Annuity Life Insurance Company ("EALIC") and the National Association of Securities Dealers, Inc. were granted leave to intervene as party-defendant and party-plaintiff, respectively. R. 23, 28–29.

The respondents have been offering and selling what they describe as "variable annuities."[1] VALIC Br. in Opp. p. 2. The Securities and Exchange Commission contends that these contracts are securities subject to the registration provisions of the Securities Act of 1933 and that respondents, although they are chartered as insurance companies by the District of Columbia Department of Insurance, are investment companies subject to regulation under the Investment Company Act. It was on this premise that the Commission instituted injunction proceedings.

Of the several types of contracts offered by the respondents, the one which has been used by the lower courts as illustrative of the pertinent characteristics of these contracts is the "Deferred Variable Annu-

[1] In the litigation in the courts below, there has sometimes been confusion by reason of the parties' utilizing insurance or investment terminology. Since either tends to assume what is sought to be proved we shall try to confine our terminology to that of contract law.

ity." R. 567–578. While other contracts specifically adapted to certain types of persons or groups, are also sold (R. 101), the material respecting the deferred variable annuity contracts which describes the investment of the purchaser's capital in the respondents' securities portfolios and the use of units to represent this investment is common to all contracts. Findings of Fact 72 and 73, R. 109.[2] Under the terms of the Deferred Variable Annuity, the purchaser promises to pay to the company a fixed sum of money, usually at specified periodic intervals. R. 567. These payments continue until a "maturity date" which has been selected by the purchaser and which, within certain age limitations, may be changed by him at any time. R. 570. During the first year, 52 percent of the payment, and during later years, a lesser percentage of the payment is deducted for sales expense, R. 615–627,[3]

[2] The District Court stated in its opinion (R. 84): "Plaintiff's Exhibit No. 1, entitled 'Deferred Variable Annuity Policy', was received in evidence as a specimen of all the contracts that employ such investment practice (Appendix 1). It was issued and sold by VALIC. For purposes of clarity and convenience, it and VALIC will be referred to with the understanding that what is said applies to all similar contracts and companies issuing them." [A footnote inserted at this place in the District Court opinion reads: "EALIC stipulated that its contracts were in all material respects the same as those issued by VALIC."]

[3] The loading charges for subsequent years are: 12% of the amount invested for the 2nd through the 5th year; 11% of the amount invested for the 6th through the 10th year; and 8% for the 11th year and thereafter. These deductions, as well as the 52% referred to in the text above, are calculated by subtracting from 100% the percentage applied to purchase accumulation units. R. 615–627. However, the percentages are calculated not on the total payments made but upon what the company desig-

and the remainder[4] is pooled with monies received from other purchasers and is invested in a portfolio of securities. Finding of Fact 45, R. 107.

This portfolio is administered by respondents and common stocks are to be bought and sold in accordance with the investment judgment of their managements based upon recommendations of investment advisers which they retain.[5] As payments are made, securities are acquired for the portfolio. In return for the money invested, the purchaser is credited with a certain number of "accumulation units." R. 568–573. These units represent the purchaser's "aliquot" or undivided interest in the portfolio of securities purchased with his money (see Findings of Fact 43–47, R. 107), and therefore his interest fluctuates in direct relation to the value of the securities portfolio. Respondents use a complicated formula to determine the value of these units. (See Appendix B, *infra*, p. 70.) During the period in which the purchaser makes payments the contract provides that he may at any time make prepayments, thus acquiring units at a more rapid rate than is provided in the contract. Finding

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nates as the "basic annuity premium". In addition, the contract provides for still another deduction of 1.8% per annum on investments. R. 138, 573, 633.

[4] Deductions are made in certain instances for various optional features. See pp. 7–8, *infra*.

[5] Sales literature of EALIC, for example, states "You avoid buying stocks on a 'hot tip.' Instead, you benefit from the counsel of expert financial advisers; the Company purchases stocks upon the recommendation of The First National City Bank of New York. In short, you get the benefit of expert diversification." (R. 899.)

of Fact 48, R. 108, 520–521, 567, 568. Or he may liquidate and withdraw all or a portion of his units.[6] R. 572–573. In that event he receives a sum equal to the then value of the proportionate share of the fund's assets represented by the units redeemed. Findings of Fact 47, 50, R. 107, 108, 170. If he withdraws all of his units during the first five years of the contract, the company charges a penalty. R. 572.

After the maturity date, a date which has been preselected by the investor, presumably as the date on which he intends to retire, the purchaser is entitled to receive a series of monthly payments of fluctuating sums representing the then value of a fixed number of annuity units. R. 568–570. These units, like the accumulation units, represent an "aliquot" share of the portfolio of the securities of the fund. Finding of Fact 70, R. 109. The number of "annuity units" upon which the monthly payment is based is derived from the dollar value of the "accumulation units" at the

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[6] By prepurchasing or by partially withdrawing units the purchaser speculates upon the short term fortunes of the company's portfolio. If he purchases units in advance, he profits if they increase in value before the time when he would have normally purchased them under the contract. If he withdraws part of his units, he profits if the units decrease in value at the time he repurchases them just as a speculator who is "short" in the market. The purchaser may do this by making a policy loan which results in a partial withdrawal of sufficient of his units to give him the cash required. In this transaction, he "borrows" from the company the value of a number of units and the number of units credited to him is reduced by that number. When he repays the "loan," units are replaced at their then current value. Thus he may replace more or less units than he borrowed when he repays the money, depending on the interim fluctuations in the value of the portfolio. R. 572–573.

maturity date, *i. e.*, the dollar value of the first monthly payment is calculated by reference to an annuity table and this is translated into the number of "annuity units." R. 568, 573.[7] These payments continue for the rest of the purchaser's life, and during this period, under contracts presently being sold, he may no longer exercise the withdrawal privilege. R. 572. A prior contract issued by VALIC, however, pursuant to which respondents are still receiving payment, provided an option for payments over a fixed number of years with no mortality feature whatsoever (R. 897). VALIC ceased to sell this contract after the instant action was begun (R. 196).

As a part of the foregoing contract the respondents offer to insurable persons a five-year decreasing term insurance policy and a provision for the waiver of payment in the event of disability of the purchaser. R. 102–103. The cost of this insurance is paid out of the purchaser's fixed payment and results in a de-

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[7] By reference to a life annuity table on a 3½% interest basis there is determined the monthly fixed dollar annuity to which the purchaser would then be entitled if he had made a single payment equal to the then value of his accumulation units. This monthly fixed dollar amount is divided by the then current value of an annuity unit and the quotient constitutes the number of annuity units whose value will be paid monthly thereafter. The 3½% interest factor used in the annuity table is neutralized in the calculation of the value of the annuity unit by a reduction factor of .9971 (the reciprocal of 1.035 per year on a monthly basis). See Appendix B. As respondents' actuarial expert Towne testified: "The .9971 is the discounted value of a dollar at the end of a month back to the beginning on the assumption of earning the monthly equivalent of three and a half percent per year." R. 532.

crease in the amount actually invested in the respondents' portfolios.[8]

Under all the contracts sold by respondents the value of the purchaser's interest fluctuates at all times in direct relationship to the changes in the market value of the portfolio securities and other assets of the fund. Findings of Fact 44–49, R. 107–108. At no time under any of the contracts issued by the respondents is any portion of the purchaser's risk of investment loss borne by the respondents (Finding of Fact 49, R. 108). Respondents assume only the risk that the purchaser will survive his estimated mortality, in which event he is entitled to be supplied with the value of additional annuity units.

Both respondents in their sales campaigns appeal to prospective purchasers who have small sums available for periodic savings (Pl. Ex. 17 and 21). VALIC advertises that it will accept a "Monthly Investment" of $25 (Pl. Ex. 21, p. 21). Great emphasis is placed upon diversification and investment in "Basic American Industries" (Pl. Ex. 21, p. 5). The VALIC literature shows in bright colors and large type the names and trade-marks of dozens of the largest and best-known companies in America, despite the fact that its portfolio contains securities of only a

[8] A male aged 35 buying a 30-year variable annuity plan and paying $1,000 annual premium would have deducted out of his total payments $101 for the decreasing term insurance policy, $1,188 for the waiver of premium provision and $3,025 for sales load, leaving a net amount for investment of $25,686 out of his total payment of $30,000. R. 619.

few of these companies.[9] Having stated that the type of diversification which is desirable is possible only through the pooling of capital, the literature goes on to depict the dangers of idle capital. Charts are displayed which show over a 110 year period the decrease in the purchasing power of the dollar. (Pl. Ex. 21, p. 9.) And a chart purportedly shows how common stock prices have kept pace with this cost of living increase over a 60-year period. Although its avowed primary appeal is to the hope of secure retirement, VALIC also indicates that funds are available for (Pl. Ex. 21, p. 20):

> "Education of children
> "Your dream
> "Business opportunities
> "Travel."

Typical of the over-all appeal to the small investor to purchase these contracts is the question asked in large red and black letters in the VALIC literature: "If today you had available $36,516.00 to provide a Life Annuity because on a plan you had systematically set aside for yourself $50 a month or $600 per year for 20 years, would you be pleased?" (Pl. Ex. 21, p. 1; R. 769.)

The foregoing facts were elicited in a two-week trial. The District Court concluded that "the logic of the law applied to the established facts seems to bring

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[9] See Pl. Ex. 21 pp. 6 and 7. A disclaimer in much smaller type states: "The industries and securities shown here are for illustrative purposes only and may or may not be included in the Company's portfolio of investments at any given time." The portfolio, set forth at R. 849–850, contains only 13 percent of the companies listed.

the variable annuity contract within the purpose and intendment of the Securities Act, and the defendants within the terms and plan of the Investment Company Act." It denied the injunction, however, on the ground that federal regulation is precluded by the McCarran-Ferguson Act (R. 89). The opinion stated that that Act was applicable because the respondents had been "chartered as insurance companies by the District of Columbia and their questioned contracts have been approved by the Insurance Superintendent of the District, and by the insurance departments of certain states" (R. 90). The opinion also stated that if the respondents had not been

> chartered, licensed and regulated by District and State authorities, and if Congress had not passed the McCarran Act, the questions raised by SEC would be answered by applying the rules of statutory construction to the Securities Act of 1933 and the Investment Company Act of 1940, and, in the opinion of this Court, such construction would bring the defendants within the purview and purpose of those statutes. [R. 90.]

The Court of Appeals affirmed the decision of the District Court, holding in addition that the contracts are within the exemptions provided by the securities laws for insurance. It stated that "The definitions in the Securities Act and the Investment Company Act indicate that if the insurance commissioner of a state subjects the business to his supervision, it is the business of insurance." R. 891.

SUMMARY OF ARGUMENT

1. Purchasers of respondents' variable annuities receive an interest the value of which is determined by the fluctuating value of a fund which purportedly consists primarily of common stocks. For this reason they need the information provided by the registration provisions of the Securities Act of 1933 and should get the benefit of the protection provided by the regulatory provisions of the Investment Company Act of 1940. Indeed, the respondents' variable annuities, except for the mortality feature which determines the duration of payments by the companies, do not differ materially from securities issued by companies which the Investment Company Act was expressly designed to regulate—periodic payment investment plans.

The legislative history of the Investment Company Act shows that, like the variable annuities, periodic payment plans had great attraction for investors having small sums of money available for periodic savings. The sales literature for these plans was of the same tenor as that used by respondents and included features, also used by respondents, which were considered objectionable. Among these were projection charts purporting to predict the future experience of a securities portfolio on the basis of general stock market averages of prior years. It was also noted in the legislative history that from the sums paid in by investors in these periodic payment plans, large, and often not fully disclosed, fees were deducted; this is also the case with respect to respondents' variable annuities.

Even though the securities sold by investment companies, including periodic payment plans, had been subject to the full disclosure requirements of the Securities Act of 1933, Congress found it necessary to enact the further protections of the Investment Company Act of 1940 giving regulatory power over such companies to the Securities and Exchange Commission.

There can be no question that the respondents fail to meet protective requirements of both the Securities Act and the Investment Company Act.

2. Since variable annuities are the kind of contract which the Securities Act was designed to cover and since the abuses attendant upon their sale are the kind of abuses intended to be remedied, they should be considered non-exempt securities within the meaning of the Act if it can fairly be construed to encompass them. The variable annuity falls squarely within the statutory definition of securities; it is a "certificate of interest or participation in any profit-sharing agreement," since its avowed purpose of keeping pace with a possible rise in the cost of living may be achieved solely through profits; it is also an "investment contract," which this Court has construed as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party * * *."

Variable annuities do not fall within the exemption for insurance or annuities. Purchasers of insurance policies or of traditional annuities are interested in

being compensated in a fixed amount upon the occurrence of a specified event; accordingly, they need not be primarily concerned with the investment policies of the company writing the insurance, if, as the Congress assumed, state supervision provided sufficient protection as to solvency and the adequacy of reserves. The purchaser of a variable annuity, on the other hand, is vitally interested in the investment risk, which will increase or decrease the amount of his return. When the statute was enacted, the term "annuity" did not include a variable annuity; the definition of an annuity then current related to a periodic "payment of a certain sum of money," which "does not vary by reason of profit or income."

The purchaser's need for information to assess his investment risk is not altered by the insurance features of respondents' variable annuities. Term insurance and a premium waiver provision, which are often sold with the contract, are in addition to its central features and were found by both courts below to be irrelevant to the issues. The mortality feature, determining the duration of the payments by the companies, seeks to solve the problem that the purchaser might otherwise outlive his savings, but this problem cannot be satisfactorily solved if his savings may be lost, or seriously diminished, through unsuccessful common stock investment. During the pay-in period of the contract there is, of course, no mortality feature whatsoever.

Whatever weight this Court feels should be given to the fact that insurance commissioners in some states

and in the District of Columbia have determined that these contracts are insurance, this fact by itself cannot be determinative of the construction to be given a federal statute and should not be given precedence over the contrary interpretation of the Securities and Exchange Commission which is the agency selected by Congress to administer the Act. Moreover, state insurance commissioners are sharply divided on whether these contracts are insurance and the only state case ruling upon a comparable contract held that it was not an annuity as that term was used and understood. *Spellacy* v. *The American Life Insurance Association,* 144 Conn. 346.

3. The respondents fall squarely within the definition of investment companies contained in Section 3 of the Investment Company Act and they are outside the exception thereto relating to insurance companies. That exception is available to a company primarily and predominantly engaged in the writing of insurance. In the light of the dominant legislative purpose of this statute, variable annuities cannot be considered insurance for the same reasons they do not fall within the exemption for insurance and annuities in the Securities Act. Moreover the basic economic factors relating to respondents' business differ substantially from those relating to insurance companies.

4. The respondents contend, and both courts below held, that the McCarran-Ferguson Act of 1945 precludes regulation of the respondents by the Securities and Exchange Commission. That Act was passed to counteract this Court's decision in *United States* v.

South-Eastern Underwriters Association, 322 U. S. 533, which determined that insurance was commerce and was subject to the antitrust laws. It was not the purpose of the McCarran-Ferguson Act to clothe the States with powers over or above those which they had prior to the Supreme Court decision. *Maryland Casualty Co.* v. *Cushing,* 347 U. S. 409.

The first answer to the respondents' claim is that basing it on the McCarran-Ferguson Act adds nothing to the argument that exemptions for insurance in the securities acts are applicable. Unless "insurance business", the term used in the later statute, covers something more than those exemptions, the arguments as to why those exemptions are not applicable is equally pertinent here. There is no basis for giving the language in the McCarran-Ferguson Act a wider interpretation.

Moreover, even on the assumption that the term "insurance business" was intended to cover more than the previous exemption, still there is no basis for finding that the Securities and Exchange Commission's authority over these contracts or the respondents was intended to be affected. As the legislative history makes clear, the McCarran-Ferguson Act was intended to reestablish the power of the States to tax and to regulate insurance, regardless of its being interstate commerce, and to suspend the application of the antitrust laws to insurance. There was no intent otherwise to affect concurrent federal power to regulate insurance.

Finally, the McCarran-Ferguson Act, by its express language, was not intended to limit the application

of any act which "specifically relates to the business of insurance" (15 U. S. C. 1012) but only to prevent a misconstruction of "silence on the part of the Congress." 15 U. S. C. 1011. In the securities acts Congress spelled out the application of their provisions to insurance and, for this reason also, the McCarran-Ferguson Act provides no exemption.

ARGUMENT

I

THE VARIABLE ANNUITY CONTRACTS OFFERED BY THE RESPONDENTS ARE NON-EXEMPT SECURITIES UNDER THE SECURITIES ACT OF 1933 ISSUED BY NON-EXEMPT INVESTMENT COMPANIES UNDER THE INVESTMENT COMPANY ACT OF 1940

A. THE FEDERAL SECURITIES ACTS WERE DESIGNED TO PROVIDE PROTECTION FOR INVESTORS PURCHASING SECURITIES SIMILAR TO THE VARIABLE ANNUITY CONTRACTS SOLD BY THE RESPONDENTS

Every purchaser of the respondents' contracts receives an interest the value of which is determined by the value of a fund, managed by respondents, which respondents represent will consist primarily of common stocks. This is the very type of situation at which both the Securities Act of 1933 and the Investment Company Act of 1940 were directed. That the contracts now being sold by respondents also include a mortality feature solely during the "pay-out period" [10] does not except them from the aim of these statutes nor decrease the need for federal regulation.

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[10] For purposes of convenience we shall refer to the period before maturity when the purchaser is making payments as the "pay-in period" and the period after maturity when he is receiving payments as the "pay-out period."

The Securities Act of 1933 provides essentially that, when an offer is made of an interest in an enterprise managed by someone other than the person who furnishes the capital, there must be full disclosure, portraying the risks as well as the possibility of profits. Persons desiring to sell securities in interstate commerce or through the mails must register them with the Securities and Exchange Commission and transmit to every purchaser a prospectus meeting the requirements of Section 10 of the Securities Act (15 U. S. C. 77e, 77j). This Section and the regulations promulgated thereunder set forth the business, financial and other information which is considered necessary for the intelligent consideration of the purchase of a security. For example, there must be complete financial statements certified by independent accountants, detailed information as to the type of venture, the risks involved, the underwriting expenses, the amount of capital needed, the interests of management and various promoters in certain financial transactions and numerous additional matters. The Commission is given various powers under the Act, including the power to make necessary rules and regulations and to enjoin violations and otherwise to enforce the Act (see *e. g.* Sections 19 and 20; 15 U. S. C. 77s, 77t).

As we have noted, the purchaser of respondents' variable annuity contracts furnishes funds which are used by the company to purchase traditional investments, primarily common stocks. The risk of loss from these investments is borne by the purchaser, who also receives the profits, after deduction of various

fees and charges. The purchaser does not participate in the management of the portfolio, but must rely on the ability of the management of the respondents and the persons whom they employ as investment advisers. The only thing that a purchaser of a variable annuity knows with any degree of certainty is what his own payments to the company will be. Even if he should see the contract—and the evidence is that the purchasers did not see the contract until they had incurred the obligation (R. 361)—he could not learn sufficient facts to enable him to exercise an informed judgment concerning the merits of the investment. The purchaser does not know the investment policy of the management, *i. e.*, what types of stock it will purchase or indeed the extent to which it might also purchase bonds, debentures, or real estate, or simply keep funds in the bank.[11] He does not know the present portfolio or the size of the company in which he is investing. The failure of sellers of securities to disclose the same type of information led to the enactment of the Securities Act.[12]

Even the full disclosure required by the Securities Act of 1933, however, was not considered adequate

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[11] Despite the emphasis in VALIC's sales literature that its portfolio was to consist of common stocks, the record shows that one and a half years after VALIC's incorporation, at the time of the District Court trial, VALIC's securities were substantially all in bonds and debentures (R. 849–50).

[12] The legislation was initiated by a message from President Franklin D. Roosevelt, dated March 29, 1933, reprinted at pp. 6–7 of S. Rep. No. 47, 73d Cong., 1st Sess., in which he stated:

"There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no

regulation for companies which were "essentially institutions which provide a medium for public investment in common stocks and other securities"—as investment companies are referred to in the Senate Report on the Investment Company Act of 1940 (Senate Report No. 1775, 76th Cong., 3d Sess. (1940), p. 2). That report points out: "Investors have suffered tremendous losses on their investment in such companies." (*Id.* at p. 3.) Largely as a result of detailed studies made by this Commission it states that there were "various problems with respect to the organization and operation of investment companies which should be remedied by legislation." (*Id.* at p. 6.)

The Senate Report discusses at some length the situation where interests were purchased in these companies on installments. It distinguishes these periodic payment plans from "programs sponsored by savings banks, building and loan associations, insurance companies, etc.," noting that the "holder of a periodic payment plan certificate is not entitled to be repaid a

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essentially important element attending the issue shall be concealed from the buying public."

The House Committee on Interstate and Foreign Commerce reported as follows (H. Rep. No. 85, 73d Cong. 1st Sess., p. 7): "No honestly conceived and intelligently worked out offering, floated at a fair but not exorbitant profit, will be injured by the revelation of the whole truth which these requirements seek to elicit. The requirement of comparable information, at the time of the offering, of many of the most fraudulent issues, in which the public has suffered the greatest losses in late years, would have prevented their flotation. A compulsory revelation of the whole truth will give impetus to honest dealing in securities and help to bring back public confidence."

fixed sum of money or a fixed amount of income, but is entitled to receive only the asset value of his certificate." (*Id.* at p. 8.) The Senate Report continues (*id.* at pp. 8–9):

> This asset value is in essence based upon the market value of the securities in the portfolio of the investment company or investment trust underlying the installment investment certificate. The amount to which the certificate holder is entitled may be less than, equal to, or more than the amount paid by the certificate holder, depending upon market prices of these portfolio securities which almost invariably consisted of common stocks. The purchaser of a periodic payment plan certificate is, therefore, speculating or investing in the stock market.

With respect to these periodic payment plans, the Senate Report also points out (*id.* at p. 9) that they:

> were specifically designed to make their strongest appeal to wage-earning men and women who were not in a financial position to invest or speculate in common stocks. As a result, these certificates were sold to housewives, domestic workers, laborers, nurses, stenographers, clerks, and others who had little financial experience. Inasmuch as the refinement and technique of the operation of periodic payment plans are intricate, they were far beyond the comprehension of the class of persons to whom these certificates were sold.

In noting that the studies had shown that these plans were the subject of flagrant misrepresentation by unscrupulous salesmen, the Senate Report specifically

referred to representations respecting "supposed similarities between the plans and savings accounts and insurance and endowment policies," concluding (*id.* at p. 10):

> Emphasis on the "savings" in the periodic payment plan literature was made in an effort to meet the sales resistance of a prospective purchaser to a speculative incursion into the investment field.

The periodic payment plans referred to in the Senate Report are identical in many respects to the variable annuity plan. Both base their sales literature upon similar appeals to the small investor seeking financial security through planned and systematic savings and both are sold for the most part in installments. The above-quoted language of the Senate Report to the effect that a purchaser of a periodic payment plan certificate is "not entitled to be repaid a fixed sum of money or a fixed amount of income," but receives a payment "based upon the market value of the securities in the portfolio," is equally applicable to the purchaser of a variable annuity. Thus the latter is also, in the words of the Senate Report, "speculating or investing in the stock market." [13]

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[13] The respondent VALIC has suggested that variable annuity contracts are not suitable for speculation because the purchaser's profits may be taxable as regular income rather than as capital gains. Br. in Opp., p. 16, fn. 10. However, speculation as used here does not mean trading in and out of the contracts, although even in that sense the contracts do contain provisions which permit a holder to guess on relatively short swings. See pp. 5–6, *supra*. Here, speculation is used in the sense that the purchaser anticipates gains or losses by reason of price fluctuations of particular stocks.

An examination of a report of this Commission relating to "Companies Sponsoring Installment Investment Plans" (H. Doc. No. 482, 76th Cong. (1940)),[14] which is referred to in the Senate Report (p. 4), illustrates numerous detailed points of similarity between the periodic payment plan and the variable annuity plan. The Installment Plan Report states (p. 3) that "[i]n order to increase the sales allurement of the plan and to strengthen the claim of 'protection' held out by the promoters, an optional provision for life insurance was generally offered, * * *." The same purpose may be attributed to the term insurance feature which is often a part of the variable annuity plan.

As to fees, the report states that in periodic payment plan offerings a "fixed percentage" of the amount paid by the certificate holder was "generally deducted in the first year of the operation of the plan from the payments made by the certificate holder" (*id.* at p. 25). It noted that since the greater part of the service fee was obtained the first year, "only a small portion of the certificate holder's payments was actually invested for him in the underlying securities until the second or third year," resulting in a "loss of dividend-earning potentialities during the first years of the plan" and losses to the investor who withdrew in the first years of the plan (*id.* at p. 34). The report notes also that in some cases "the certificate holder's funds after investment were subject to management fees or supervisory fees"

[14] This will be referred to herein as "Installment Plan Report."

(*id.* at p. 38). In addition, the report points out (*id.* at p. 26) that "[u]pon withdrawal or redemption of the installment investment plan certificate by the holder prior to maturity, the net proceeds of the certificate holder's account was occasionally subject to withdrawal or termination fees."

As previously noted, *supra,* p. 4, the respondents here make an initial charge of 52 percent of the first year's investment; the contract provides for an additional annual charge of 1.8 percent of the investments, comparable to the management fees discussed in the report (which were stated to bear "no relationship to any actual management of the * * * fund" (*id.* at p. 38)); [15] and for a termination fee during the first five years of the contract. The same problems arising from the fees charged in connection with periodic payment plans necessarily obtain with respect to respondents' fees.

Examination of the Installment Plan Report discloses numerous other parallels between the periodic payment plans and the respondents' plans. The report notes for example that all contracts were not sold by installments but that "to attract the funds of those who could afford to make a fairly substantial lump sum investment, a 'fully paid certificate' was also sold" (*id.* at p. 3). Respondents, in addition to their usual installment contract, also sell a deferred single-payment contract (R. 677). The periodic payment plans contained a provision "in many instances * * *

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[15] This fee is hidden in the rather complicated formula for the computation of the value of the accumulation unit and annuity unit. See Appendix B, *infra,* p. 70.

for partial withdrawal." (Installment Plan Report, p. 30) Respondents advertise an almost identical provision (R. 775). Under some periodic payment plans, the report states (p. 32), provision was made for loans to a certificate holder "with his net investment as collateral." A similar provision is contained in respondents' contracts (R. 572). The report notes also (p. 31) with respect to periodic payment plans, as is true in the case of respondents' plans, that the "completion of payments * * * was generally termed the maturity" of the plan.

In the realm of sales promotion the similarities between the respondents' plans and the periodic payment plan are striking. The Installment Plan Report states (p. 6) that, by reason of the "construction and nomenclature of the installment plan" and the kind of publicity used, there was given an impression "that these plans were similar to savings bank thrift plans or insurance endowment plans." The selling literature used in connection with the sale of periodic payment plans was of a similar tenor to that used by respondents. See pp. 8–9, *supra*. The report points (p. 165) to the "emphasis placed upon the 'great corporations,' the common stocks of which underlay the installment plan," noting that there was a "tendency to confuse the soundness of the 'great corporations' with the soundness of the installment plan, by many certificate holders." The report also contains various typical selections of sales literature used for periodic payment plans, including the following:

> An Insured Investors Income-Building Plan makes it possible for YOU to participate in the

earnings of 32 leading industrial corporations of America, corporations upon whose functioning depends the very structure of our economic system. [Installment Plan Report, p. 165.]

Commonwealth Fund Provides Living Assurance by Enabling You Now to—

Create a Living Trust for the education of your children.

To buy your own home or establish a business.

To provide a sinking fund or business reserve.

To meet an emergency or an opportunity.

For travel and comfort in your later years.

LIVING ASSURANCE means peace of mind—security and freedom from financial worry. [*Id.* at p. 167.]

What could be nicer than a Comfortable Old Age, with an assured monthly income from your own estate? Regular dividend checks. Freedom from financial worries. Let the profits of American Industry help you build your estate. [*Id.* at p. 168.]

One of the most troublesome features in connection with the selling literature of the periodic payment plans was the use of "projections," and charts of previous market prices. The report states (p. 171):

Imposing charts and statistical material formed a considerable part of the sales approach of the installment plan distributor. Naturally, the statistics and analyses presented to the public were favorable to the plan. Periods of time were chosen when they particularly favored the interpretation desired by

> the sponsor. Past performances of securities in the market were projected into the future to "prove" the selling argument of the sponsor. "Projections," upon which "reasonable predictions" were made, even selected general security prices as far back as 1900 and 1910 to show the probability of the appreciation of the underlying stocks in the future.

This language could have been written about the sales kit used by VALIC which displays the trade marks of corporations whose stocks are not contained in its portfolio and uses charts predicated on the performance of hundreds of stocks for periods of time during most of which VALIC was not in existence. Pl. Ex. 21, pp. 6–7, 22–25. Indeed one of its market charts goes back to 1897. Pl. Ex. 21, p. 10. Plaintiff's selling literature contains a disclaimer of "assurance to the policy-holder" as to the continuance of past trends (*ibid.*) but the Installment Plan Report noted (p. 172) that even where such assurances were given "the possibilities for abuse in the use of such projections remained. Salesmen could still take advantage of a credulous prospect. The figures were misleading and did not give a complete picture of the hazards involved."

Finally, in connection with the sales methods used, the report noted the admitted "difficulty in enlightening the prospective purchaser of the installment investment certificates" on the subject involved. It stated (p. 22).

> Security dealers and salesmen themselves encountered difficulty in understanding the plans.

In order to make clear the terms and implications of the plan, detailed and careful disclosure was required, particularly because of the type of investor to which the plan appealed.

We submit that respondents' plans are, if anything, more complicated than the periodic payment plans of which the report speaks. (See Appendix B, p. 70, *infra.*)

The Investment Company Act of 1940 was enacted to deal with the problems pointed out in this and other reports of the Commission.[16] The Act states that it is based on the "facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935 [15 U. S. C. 79[illegible]-4], and facts otherwise disclosed and ascertained * * *." (See Section 1 (a) and Section 1 (b); 15 U. S. C. 80–1a (a) (b)). The latter Section declares "that the national public interest and the interest of investors are adversely affected—

"(1) when investors purchase * * * securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management; * * *."

[16] Section 1 (a) (5) (15 U. S. C. 80a–1 (a) (5)) declared that investment companies are affected with a national public interest because, among other reasons, the activities of such companies "extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors."

That section also sets forth the rule of construction to be followed in interpreting the provisions of the Act, by declaring "that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

The Investment Company Act generally requires registration of investment companies by making it unlawful for unregistered companies to make use of the mails or the instrumentalities of interstate commerce in the operation of their business (Section 7; 15 U. S. C. 80a–7). Registration with the Commission pursuant to Section 8 (15 U. S. C. 80a–8) subjects the company to the broad scope of regulation under the Act, which includes restrictions on the personnel, capital structure, and other activities of a registered investment company and its affiliated persons. See *e. g.* Sections 9, 10, 17 and 18; 15 U. S. C. 80a–9, 10, 17, 18. Section 8 requires that the management adopt a set of fundamental investment policies concerning, *inter alia,* the diversification of the investment company's assets; the borrowing of money; the concentration of investments in any one industry or group of industries; the purchase and sale of real estate; and portfolio turnover. Once adopted, Section 13 (15 U. S. C. 80a–13) makes it unlawful to deviate from these fundamental policies without a vote of its security holders. The Act also emphasizes the importance of the investment adviser. Section 15 (15 U. S. C.

80a–15) requires that he may only serve pursuant to written contract approved by the security holders which shall include the fees to be paid him and contain provisions for its termination at the will of the security holders or automatically in the event of its assignment.

Section 27 of the Act (15 U. S. C. 80a–27) is devoted entirely to "periodic payment plans." It provides, among other things, that it is unlawful for companies "issuing periodic payment plan certificates * * * to sell any such certificate, if—

> (1) the sales load on such certificate exceeds 9 per centum of the total payments to be made thereon;
>
> (2) more than one-half of any of the first twelve monthly payments thereon, or their equivalent, is deducted for sales load; * * *

The Commission has authority under the Act to make rules and regulations (see *e. g.* Section 38; 15 U. S. C. 80a–37) and to enjoin violations and otherwise to enforce the Act and rules thereunder (Sections 36 and 42; 15 U. S. C. 80a–35, 41).

Purchasers of respondents' variable annuities have no protection comparable to those afforded by the Investment Company Act. As indicated above, the respondents' charges are in excess of those permitted under Section 27 of the Act. Respondents' sales literature violates in many respects a Statement of Policy, adopted by this Commission in connection with its administration of the Securities Act of 1933 and the Investment Company Act of 1940, in which the Com-

mission enumerates certain practices with respect to sales literature of investment companies that the Commission believes are "false and misleading". The Statement of Policy was first adopted in 1950 after comprehensive studies of sales literature used in the sale of investment company shares and, after opportunity to all persons to comment on drafts of the proposed statements, it has been twice revised in the light of subsequent experience.[17] It sets forth standards with respect to representations as to such matters as the rates of return on the investor's capital, the safety of his capital,[18] the effect of government supervision on the management of the company, the benefits of dollar averaging and continuous investment, and the amount of the commissions charged. It limits the use of reprints from articles relating to the whole investment company industry. It restricts the use of charts using information based on market indices.[19] Respondents' utilization of Dow-Jones in-

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[17] Securities Act Release No. 3385 (1950), 15 Fed. Reg. 5468; Securities Act Release No. 3530 (1955), 20 Fed. Reg. 791; Securities Act Release No. 3856 (1957), 22 Fed. Reg. 8977.

[18] For example, the Statement of Policy states that it will be materially misleading:

"To discuss accumulation of capital, preservation of capital, accumulation of an estate, protection against loss of purchasing power, diversification of investments, financial independence or profit possibilities without pointing out or explaining the market risks inherently involved in the investment." 15 Fed. Reg. 5468.

Cf. VALIC's advertisement that its contracts are "INFLATION-PROOF ANNUITIES" (R. 761).

[19] The Statement of Policy spells out in detail specifications to which charts should conform. It states generally that it will be considered materially misleading:

"To use any chart or table which is inaccurate in factual detail or tends to create a false or misleading impression as to

dustrial average and Standard and Poor's 480 Stock Combined Index as an indication of the assumed performance of a variable annuity in the past (Pl. Ex. 21, pp. 8, 13) is a gross violation of the standards set forth in the Statement of Policy.[20] Indeed, under that Statement it is improper to use charts which contain statistics antedating the fund or company involved.

Approximately ten billion dollars of assets are held by numerous open-end investment companies, whose shares represent interests similar to the respondents' accumulation units and whose methods of valuation of these shares is basically the same as the method followed by respondents in valuing the units they sell (R. 725). Many of these companies sell periodic payment plans and, like respondents, receive their funds primarily through installments. Certain of these, such as United Funds, Inc., referred to in the findings of the district court, sell insurance in con-

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any material aspect of the investment company's past performance or of an assumed investment of any investor in the investment company, or appears to represent that the investment company's past performance or investor experience will be repeated in the future. * * *" 22 Fed. Reg. 8978.

[20] It is never explicitly stated that to have achieved a similar investment result respondents would have had to invest in these securities in equal proportions. Even assuming that respondents could or would wish to invest in all the shares upon which the Standard and Poor's Index is based and even making the wholly unwarranted assumption that those stocks would have the same yields and appreciation as in years past, the amount invested with respondents could not have a similar increase in value because of the large deductions enumerated above. (Page 4, *supra*.) As we have seen in footnote 11, *supra*, page 18, VALIC's portfolio is almost all invested in bonds and debentures.

nection with their plan and their salesmen "are required to be licensed as insurance salesmen by the Insurance Commissioners of some states and by the Superintendent of Insurance of the District of Columbia." (Finding of Fact 84, R. 110). Another investment company selling periodic payment plans will by arrangements with an insurance company, at the maturity of their contracts, convert the value thereof into an annuity based upon a mortality table guaranteed at the inception of the plan (R. 805–12). These companies are registered with this Commission under the Investment Company Act of 1940 and their contracts are registered pursuant to the Securities Act of 1933.

As we indicated in the petition for certiorari, the Commission has no desire to prevent economic experimentation whereby an individual might be able to provide adequately for his years of retirement in the face of a possible rise in the cost of living. Such experimentation, however, must be within the framework of the restrictions imposed by Congress upon persons seeking to obtain the funds of others for investment. The mere fact that the contract involved is claimed to be an "attempt to solve a problem badly in need of solution," as noted by the court below (R. 891), is not sufficient to remove it from otherwise applicable federal regulation. Indeed, the originators of the periodic payment plans also "claimed that these plans were created and developed in order to fill an economic need" (Installment Plan Report, p. 3).

The provisions of the Securities Act and of the Investment Company Act must be read in the light of

their background and the purposes, described above. Since the nature of the enterprises here involved and the possibilities of abuse inherent in the sales of their contracts fall squarely within the intent of Congress, the language of the two Acts should be read to cover the sales of these interests, if it can fairly be done. We shall show below that the Acts are properly construed to apply to the respondents and their contracts.

B. THE VARIABLE ANNUITY CONTRACTS ARE NON-EXEMPT SECURITIES UNDER THE SECURITIES ACT OF 1933

The respondents have argued in the courts below that the contract they offer for sale is not a "security," as that term is defined in the Securities Act of 1933 [21] and that in any event it falls within an exemption from registration applicable to "Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner * * * or any agency or officer performing like functions, of any State * * * or the District of Columbia." [22] In determining these questions, as this Court has indicated, "The focus of inquiry should be on the need of the offerees for the protections afforded by registration." [23]

The purchaser of a security is interested in the amount of return on his investment and the possibility of profit, and he must weigh against these the risk of decline in income and of loss. His risk is identical

[21] Section 2 (1) (15 U. S. C. 77b (1); Appendix A, *infra*, p. 63.

[22] Section 3 (a) (8) (15 U. S. C. 77c (a) (8)); Appendix A, *infra*, p. 63.

[23] *Securities & Exchange Commission* v. *Ralston Purina Co.*, 346 U. S. 119, 127.

to that of all others who purchase the same security. Since the purchaser of a security can learn little of the merits of a proposed investment by means of the document evidencing participation therein,[24] the Securities Act requires full disclosure to enable him adequately to appraise his investment risk.

The purchaser of insurance or of a traditional annuity, on the other hand, is interested in being compensated in a fixed amount upon the occurrence of some hazard which is personal to him but to which many are susceptible, as for example early death or living beyond an anticipated life span. Since insurance companies were at the time of the passage of the Securities Act regulated by the individual states to give assurance that they should be solvent and able to carry out their obligations, and since the interests of persons buying insurance was in whether the insurance companies would be financially able to pay the agreed compensation, rather than in investment policies which would determine the day-to-day market values of the companies' investments, Congress provided an exemption for insurance (Section 3 (a) (8), Appendix A, *infra,* p. 63), just as it did for bank deposits and building and loan shares (Section 3 (a) (2) and (5) of the Securities Act, 15 U. S. C. 77c (a) (2) and (5)), apparently determining that it was not necessary to require sellers thereof to furnish all the information required by the Securities Act.

The purchaser of a variable annuity will be compensated not in a fixed amount, however, but on the

[24] It is noted in the House Report on the Securities Act "that securities are intricate merchandise." H. Rep. No. 85, 73d Cong., 1st Sess. (1933), p. 8.

basis of units of a portfolio of common stocks purchased by the company. Hence, there exists not only the personal hazard but also the investment risk common to all purchasers of securities. As respondents' expert testified, the variable annuity cannot insure against this investment risk (R. 460).[26] Accordingly, the purchaser of a variable annuity, like any other purchaser of securities, should be advised of all material information bearing on his investment.

Examination of the definition of a security in Section 2 (1) of the Securities Act (15 U. S. C. 77b, Appendix A, *infra*, p. 63) and of the exemptive provisions for insurance policies in Section 3 (a) (8) of that Act (15 U. S. C. 77c (a) (8), Appendix A, *infra*, p. 63), interpreted as they must be in the light of the dominant legislative purpose discussed above,[27] makes it clear that the variable annuities sold by respondents are not exempt securities. The term

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[26] Professor Mehr, a professor of economics specializing in insurance (R. 453), testified on behalf of respondents (R. 460):

"Now, if a person owns, if a group of people all own, a given investment, if that investment goes bad, all those owning such investment would lose and there would be no way in which that loss can be shared among those who are exposed to that loss, so that it is impossible to have two things—prediction of loss and sharing in the predicted loss; therefore, it is not insurable."

[27] See *Securities & Exchange Commission* v. *Joiner Corp.*, 320 U. S. 344, 350–351, where this Court, in construing the definition of a security, pointed out that "courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy."

"security" is broadly defined by Section 2 (1) of the Act. As Mr. Justice Jackson pointed out in *Securities & Exchange Commission* v. *Joiner Corp.* (320 U. S. 344, 351):

> * * * the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as "investment contracts," or as "any interest or instrument commonly known as a 'security.'"

The contracts sold by respondents are clearly "certificate[s] of interest or participation in any profit-sharing agreement" within the language of Section 2 (1) of the Securities Act (15 U. S. C. 77b). The purpose of providing a fund and retirement income which might be able to keep pace with a rising cost of living can be achieved only through profits. Indeed, this purpose has historically been a function of investment in equity securities. As we have seen, respondents' contracts are basically similar to periodic payment plans sold by investment companies, which also fall squarely within this definition. The fact that respondents borrow insurance terminology cannot affect the essential nature of the instrument. As indicated in *Securities & Exchange Commission* v. *Howey Co.*, 328 U. S. 293, 298, "form" must be "disregarded for substance" and emphasis must be "placed upon economic reality."

Variable annuities are also "investment contracts," another statutory term used in defining a security (15

U. S. C. 77b). In both the *Joiner* and the *Howey* cases it was held that the term "investment contract" encompassed an instrument which in form was an interest in real estate but which by reason of extrinsic facts became a contract primarily for the "placing of capital or laying out of money in a way intended to secure income or profit from its employment." (*Securities & Exchange Commission* v. *Howey Co.*, 328 U. S. at 298.) In the *Howey* case this Court defined "an investment contract for purposes of the Securities Act" as "a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, * * *." (328 U. S. at 298–299).[28]

The contracts issued by respondents come directly within this language. Under the terms of these contracts, payments, or "investments," as one of the purchasers referred to them (R. 362), were made to the

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[28] The decision of the Fifth Circuit in *Haberman* v. *Equitable Life Assurance Society*, 224 F. 2d 401, 225 F. 2d 837, certiorari denied, 350 U. S. 948, is not authority for the respondents' claim that their contracts are not securities. That case dealt with an ordinary annuity with no variable feature and held that it was insurance, not a security. The reasoning of the court would seem inapplicable to the novel type of contract here involved. Moreover, the case does not deal with the Securities Act at all, but with the Texas law. That statute borrowed from the federal Securities Act certain language in defining the term security, but it did not follow the federal law in providing an exemption for insurance. Since the court was convinced that the interests sold were clearly insurance and that there was no intent to impose securities regulation on insurance companies, it construed the definition as excluding the annuity contract involved.

respondents in return for an undertaking by the respondents to manage the funds and to apply any profits or losses which might result from that management to the interest held by the purchasers of the contracts. The purchasers are motivated in large part by the desire for profit arising from the appreciation in stock market values to enable them to keep pace with any rise in the cost of living. The District Court found (Finding of Fact 74, R. 109–110);

> A VALIC and an EALIC contract holder invests money with the respective defendants with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased by VALIC and EALIC with the money invested by the contract holder, and his expectation of profit based upon the efforts of others applies to both the "accumulation period" and to the repayment or variable annuity period.

The need of a purchaser of a variable annuity for information with which to assess his investment risk is important not only in determining whether the variable annuity is a security but also in determining whether it is exempt from registration.[29] As this

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[29] Section 3 (a) (8) of the Securities Act (15 U. S. C. 77c (a) (8)) provides:

"Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities:

* * * * *

"Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions,

Court pointed out in *Securities & Exchange Commission* v. *Ralston Purina Co.*, 346 U. S. 119, 125, in dealing with another exemptive provision of the Act:

> Since exempt transactions are those as to which "there is no practical need for [the bill's] application," [i. e. the Securities Act's application] the applicability of * * * [the exemption] should turn on whether the particular class of persons affected needs the protection of the Act.

There can be no question that the term "annuity contract" used in Section 3 (a) (8) was not specifically designed to encompass "variable annuities" since there were no variable annuities in 1933 when the Act was adopted. The differences between a variable annuity and an "annuity contract", as such contract existed in 1933, eliminate the reason for the exemption.

The term "annuity" was defined in the early 17th Century by Sir Edward Coke as "the yearly payment of a certain sum of money" [30] and that definition has continued to be standard. A leading authority on annuities, in a book published in 1933, the date when the Securities Act was passed, stated:

> Briefly defined, an annuity represents a series of certain payments, generally equal in amount, made at uniformly recurring intervals of time

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of any State or Territory of the United States or the District of Columbia;"

* * * * *

[30] This was quoted in Mehr and Osler, *Modern Life Insurance* (1949), p. 70.

> to a named person or persons during the continuance of a specified condition or status. * * * There is a difference, strictly speaking, between an annuity and a periodic income. While an annuity, as previously stated, represents a definite sum guaranteed to be paid, an income is made up of net profits after deducting all necessary expenses and charges, and, therefore, may be indefinite in amount. An annuity does not vary by reason of profit or income.[31]

There may have been minor variations in the definition of annuity but, as respondents' expert, MacLean, conceded, "any definition of an annuity which was promulgated, written, prior to the year 1952, naturally did not contemplate or include within its terms the possibility of a variable annuity" (R. 490).

Since the purchaser of a variable annuity needs the protection of the Securities Act to evaluate his investment risk, the fact that the variable annuity also has certain insurance features does not bring it within the exemption of Section 3 (a) (8). The insurance features are (1) the five-year diminishing term insurance and the premium waiver provision often sold with the variable annuity and (2) the mortality factor during the pay-out period of the variable annuity contract now being sold. As to the

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[31] Crobaugh, *Annuities and their Uses* (1933), p. 25. Authorities cited by respondents in the courts below are in accord with this definition. See Jordan, *Life Contingencies*, pp. 50–52; *Proceedings of the Casualty Actuarial Society*, Vol. 23, Part II, No. 28, May 13, 1927, reprinting "The Early History of the Annuity," by Edwin H. Kopf; Pitman, *Dictionary of Life Assurance* (1930), p. 61.

first, we note that only a very small percentage of the investor's payments is allocated to term insurance or premium waiver (p. 8, *supra*), that diminishing term insurance may also be a feature of the periodic payment plans (R. 110 and see p. 22, *supra*); and that the courts below found "to be irrelevant" the fact that term insurance was sold (R. 888 and see R. 83–84. The mere fact that a company may be incidentally selling insurance does not make it an insurance company. Cf. *Bowers* v. *Lawyers Mortgage Company*, 285 U. S. 182, 190, where this Court held that the issuance of guarantees constituted an insurance business, but that where this was merely an incidental part of a company's business the company cannot be considered an insurance company within the meaning of the Internal Revenue Code.

As to the fact that payments during the pay-out period must be continued throughout the the purchaser's life, the contracts purportedly seek to remedy not only the problem that an individual, who has accumulated savings, may find that over the years these have been reduced in value by reason of a higher price level, but also the problem that he might outlive any periodic withdrawal of his savings. The second problem cannot be satisfactorily solved, however, if in an attempt to solve the first the savings can be lost or seriously diminished through unsuccessful common stock investments. Thus, although as VALIC points out (Br. in Opp. 16), the traditional annuitant "prospers when he outlives his expectancy," it is possible that the holder of a variable annuity who outlives his life

expectancy could lose in the event of his company's having an unsatisfactory investment experience. Accordingly, even if the insurance aspect could be separated from the investment aspect and were considered of equal importance, to paraphrase the language of the committee report, quoted in the *Ralston Purina* case at p. 39, *supra,* there would still be a "practical need" for the protections of the Securities Act—that is, the investor's need for full information as to the nature of that investment risk—and, hence, the Act must be held applicable.[32]

During the accumulation period, which presumably is the longer period during which the contract is in existence, the death of the purchaser will not affect the value of his participation in respondents' portfolio of securities. As the District Court found (R. 108):

> 59. No mortality features are involved in the calculation of the number of "accumulation units" or their value.
>
> 60. During the first 5 years there is a mortality consideration only with respect to a small portion of the premium paid during that period, and then only if the contract holder has the

[32] It should be noted in this connection that, as pointed out at page 7, *supra,* until the Commission instituted the present action one of the contracts sold by the respondents had an optional provision for payment solely for a definite number of years without any reference to the death or survival of the purchaser. This indicates that the respondents themselves have not considered the mortality factor essential, and that their primary purpose is to induce members of the public to entrust their money to the respondents for investment as a hedge against inflation. Purchasers are still investing under plans containing the option which involves no mortality feature.

five-year term insurance or the disability premium waiver.

During the accumulation period, the purchaser is entitled to redeem his units at their then current value, that is, he can cash in his aliquot share of respondents' portfolio. If he should die, his beneficiary or his estate receives the identical value of his participation, either in cash or through an alternate option presumably of the same value. Since the pay-in period of the contract is separable at the will of the purchaser from the pay-out period (R. 108) and since during the former period it does not differ in any essential characteristic from an ordinary contract for the periodic accumulation of investment company shares (see pages 19–27, *supra*), it should not be exempt from registration under the Securities Act, whatever the determination with respect to the pay-out period.

Application of the Securities Act does not prevent states from also exercising jurisdiction. Indeed, Section 18 of the Act (15 U. S. C. 77r) specifically contemplates concurrent regulation by the Securities and Exchange Commission and by state securities commissions, some of which have jurisdiction over insurance. See *Travelers Health Association* v. *Virginia,* 339 U. S. 643, 653.

The courts below placed great emphasis on the fact that the Superintendent of Insurance of the District of Columbia has licensed the respondents to do business in the District. Both courts also noted similar action by other state authorities. R. 90–91, 890. However, this licensing, by itself, cannot be deter-

minative of the question of whether the contracts are exempt under Section 3 (a) (8) of the Securities Act. To be sure, regulation of the issuing company by an insurance commissioner is one condition precedent to the exemption of insurance or annuity contracts from the federal securities commission's jurisdiction.[33] But it still must be found that insurance or annuity contracts are really involved, and the federal legislation does not refer that determination to the local authorities.[34] Whatever weight the courts should accord to the opinions of local authorities, their judgment should not be given precedence over the interpretation adopted by the Securities and Exchange Commission, the authority set up by Congress to administer the Act.[35]

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[33] The exemption under Section 3 (a) (8) of the Securities Act requires first a determination that the instrument involved is an "insurance or endowment policy or annuity contract or optional annuity contract" and then, as an additional qualification, that it be "issued by a corporation subject to the supervision of the insurance commissioner * * *."

[34] If the exemption had read "any contract sold by a company licensed to sell insurance by any state authority" or "any security determined to be insurance by any state authority", then the granting of the license or the determination by the Commissioner would of itself have been the determinative factor. On such a basis, securities issued or guaranteed by any state are for that reason, without more, exempt. Section 3 (a) (2); 15 U. S. C. 77c (a) (2). On the other hand, the statute, as enacted, conditions the exemption of insurance upon the action of the state agencies, but does not make such action determinative.

[35] *Securities & Exchange Commission* v. *Associated Gas & Electric Co.*, 99 F. 2d 795 (C. A. 2); cf. *United States* v. *Allen-Bradley Co.*, 352 U. S. 306; *National Labor Relations Board* v. *Denver Building Council*, 341 U. S. 675; *United States* v. *American Trucking Associations, Inc.*, 310 U. S. 534.

Moreover, state authorities differ sharply as to the nature of variable annuities. A poll of thirty-seven states made in 1957 by the National Association of Securities Administrators indicated that insurance commissioners are about evenly split on the question whether or not to approve the variable annuity for sale as insurance, while the securities commissioners are almost unanimous in their opinion that the variable annuity is a security.[36] The only court decision concerning a contract which is substantially identical to the variable annuity contract is *Spellacy* v. *The American Life Insurance Association,* 144 Conn. 346, 131 A. 2d 834 (1957).[37] That case dealt with a "vari-

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[36] 1 C. C. H. Blue Sky Report, Para. 4,711.

[37] The court described the contract there involved as follows (131 A. 2d at p. 839):

"Upon the exercise of this option, the defendant agrees to grant a variable annuity certificate, or policy, for any one of five types of annuity payments. The variable annuity policy is to be issued 'for such total number of variable annuity units, payable monthly or as may be agreed, as the cash redemption value of the accumulated variable endowment units * * * shall purchase at the initial conversion value of the Variable Annuity Units in effect when the [policy] is issued.' A minimum is fixed at 1000 variable annuity units. The endowment policy recites that '[t]he objective of the contract for Variable Annuity Certificate will be the preservation and increase of the relative purchasing power of the initial dollar value of the annuity units.' In line with this objective, the dollar return from the annuity units would fluctuate with the value and the amount of return from the corpus of the fund from which the annuities are paid."

An "Estate Builder" contract, having certain features of the variable annuity contract and using insurance terminology was held to be an attempt to sell an investment as insurance in *Coastal States Life Insurance Company* v. *Kelly*, Court of Common Pleas, Richland County, So. Car., June 1955, unre-

able endowment" contract with a "variable annuity" option at the maturity date. The court stated (131 A. 2d at p. 839):

> The policy to be issued under the annuity option would provide for the payment, not of a fixed amount of money, but of an uncertain sum, which is quite different from the legal concept of the word "annuity." Here again, the legislature employed a term generally used and understood, and it must be assumed that it did so intending that annuity payments should be in definite sums of money.

The court recognized that the dollar might depreciate, but stated that whereas such depreciation was an economic risk which an insured ran, the person payable in the dollar value of units ran not only economic risks but also the risk of depreciation from factors other than economic. It stated (p. 840):

> There is a real distinction, however, between the general depreciation in the value of the dollar and the depreciation which may occur in the value of units in a variable endowment or annuity fund such as is contemplated in the present case. The former is due to widespread economic factors affecting all alike. The latter may be due to such factors, reflected in a general decline in the market value of securities

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ported. On July 21 and 22, 1958, there was a trial in West Virginia on a complaint for injunction instituted by the Securities Commissioner of that State to prevent VALIC from selling their contracts in violation of the securities laws of West Virginia. No decision has been rendered in that action as yet. *State of West Virginia* v. *Variable Annuity Life Insurance Co.*, Circuit Court of Kanawha County, W. Va., Docket No. 24,449.

rather than in the depreciation of the dollar, but it may also be due to possible poor judgment or lack of skill in the management of the investments in the particular fund. When an endowment or annuity is payable in a specified number of dollars, an insured runs the risk of depreciation of the dollar. When it is payable in variable endowment or annuity units, he runs the risk of depreciation of the unit, measured in dollars, including the added risk that it may be depreciated by reason of factors not traceable to general economic conditions. The defendant escapes this type of risk and transfers it to the insured.

Accordingly the court held that the contracts involved were not insurance or annuity policies and could not be issued by insurance companies.

In view of the difference in approach by the insurance agencies in the District of Columbia and Connecticut, what should be the status of contracts approved as insurance in one state and disapproved in others? Since, under Section 3 (a) (8) of the Securities Act, supervision by *any* state commission suffices to provide an exemption, investors of the states which do not treat the contracts as insurance would, if licensing by one were determinative on the question of whether the contract constitutes insurance, be deprived of the protection of the federal law by reason of the interpretation of some other state. This is contrary to the entire notion of the Securities Act. See Message of President F. D. Roosevelt to Congress dated March 29, 1933, reprinted in S. Rep. No. 47, 73d Cong., 1st Sess.

Whatever interpretation might be placed on the variable annuity contracts in other contexts, they are almost classic illustrations of the type of instruments which should be registered in order to afford the purchaser the full protections intended by the Securities Act. The potential evils at which the statute is directed are most apparent when the security represents an equity interest in a corporation or represents an interest in a pool of common stocks which themselves represent equity interests in many corporations. Under such conditions the security depends for its value upon so many factors which may be unknown to the investor that all pertinent financial facts should be disclosed to the investor if the remedial purpose of the statute is to be effectuated.

C. THE RESPONDENTS ARE NON-EXEMPT INVESTMENT COMPANIES UNDER THE INVESTMENT COMPANY ACT OF 1940

The Investment Company Act of 1940 defines an investment company as an issuer which "is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities" (Section 3 (a) (1); 15 U. S. C. 80a–3 (a) (1), App. A, *infra*, p. 65); or as an issuer which "is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets * * *" (Section 3 (a) (3); 15 U. S. C. 80a–3 (a) (3)). There can be no question but that the respondents are engaged in the business of investing, reinvesting, own-

ing, holding and trading in securities. It is by means of this investment and reinvestment that they purport to enable the purchasers of the contracts to keep pace with the cost of living (R. 86). It is around this investment and reinvestment that all of their operations, other than sales, are centered. An investment adviser is employed and featured in their sales literature (R. 758). Their assets consists almost exclusively of investments in securities. The success or failure of the company will depend largely upon the success or failure of its investment experience.

Respondents contend, however, that they are not required to comply with the registration provisions of the Investment Company Act by reason of Section 3 (c) (3) (15 U. S. C. 80a–3 (c) (3), App. A, *infra*, pp. 65–66), which excepts from the definition of investment company "[a]ny bank or insurance company; * * *" An insurance company is defined by Section 2 (a) (17) of the Act (15 U. S. C. 80a–2 (a) (17), App. A, *infra*, p. 66) as a "company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; * * *"

These definitions, like the definitions in the Securities Act of 1933 discussed above, must be construed in the light of the "dominating general purpose" of the Act (see p. 35, *supra*). Section 1 (b) of the Investment Company Act (15 U. S. C. 80a–1 (b)) states

that the Act was designed "to mitigate and, so far as is feasible, to eliminate" previously existing abuses, including *inter alia* misleading sales methods and inadequate information as to the company's investment policies. As we have seen in Point I, A, *supra*, the legislative history of this Act is replete with references to the need for legislation for periodic payment plans by reason of their characteristics identical to those of the variable annuities.

In Point I, B, *supra*, we have shown that the contracts sold by appellees are securities. The business of appellees, therefore, is primarily and predominantly that of selling securities and investing and reinvesting the proceeds from those sales for the benefit of the security holders. Such insurance as may be sold in connection with the sale of the security (see p. 7, *supra*) plays so small a part in the scheme and purpose of respondents' activity that it cannot be considered their "primary and predominant business activity."[38] That the Act contemplates that securities sold by a registered investment company

[38] The only case decided by an appellate court where it was claimed that a company was entitled to an exemption from the definition in Section 3 (a) of the Investment Company Act is *Bankers Securities Corp.* v. *S. E. C.*, 146 F. 2d 88, 92 (C. A. 3). The court there stated that the Commission was "justified in and required to take the sum total of the activities" of the person claiming the exemption in reaching its determination whether that person was subject to the Investment Company Act. In that case it was contended that the petitioner, which had substantial interests in department stores and in real estate, was not "primarily engaged" in the business of investing and reinvesting in securities. The court upheld an order of the Commission denying the application for an exemption.

may include insurance features is clear from Section 28 (a) (2) (G) (15 U. S. C. 80a–28 (a) (2) (G)), which requires certain investment companies to maintain "such appropriate contingency reserves for death and disability benefits * * * on any such certificate providing for such benefits or rights as the Commission shall prescribe by rule, regulation, or order based upon the experience of face-amount companies in relation to such contingencies."

Not only do the respondents fall technically outside the exemption for insurance companies, but also the basic economic factors relating to respondents' business differ substantially from those relating to insurance companies. An insurance company has to meet fixed obligations and will be insolvent if its investment policy is such that the insurance obligations cannot be met. Therefore, there is great economic pressure to invest conservatively. Respondents, however, are under no such pressure, since payment on variable annuities is made without reference to fixed dollar obligations. It is true that increased sales with resulting profits to the company would result from successful operation, but the chance of spectacular success through speculative investment policies might sometimes outweigh considerations of safety.

The fact that a company is subject to the Investment Company Act does not preclude state regulation of its contracts. Section 24 (d) of the Investment Company Act (15 U. S. C. 80a–24 (d), App. A., *infra*, p. 67) provides that the exemption in Section 3 (a) (8) (15 U. S. C. 77c (a) (8)) of the Securities Act, relating to

insurance policies, "shall not apply to any security of which an investment company is the issuer." This necessarily contemplates dual regulation by an insurance commissioner and the Securities and Exchange Commission in the situation where an investment company sells insurance policies, since the exemption of Section 3 (a) (8) is applicable only to policies subject to state regulation (see p. 44, *supra*). Finally, Section 50 (15 U. S. C. 80a–49, App. A, *infra*, pp. 67–68) provides that nothing in the Act shall affect the jurisdiction "of any State or political subdivision of any State, over any person, security, or transaction, insofar as such jurisdiction does not conflict with any provision of this title or of any rule, regulation, or order hereunder."

For the reasons pointed out in our discussion of the exemption under Section 3 (a) (8) of the Securities Act (pp. 43–47, *supra*), the fact that state authorities may consider the respondents to be insurance companies is entitled to less weight than the views of this Commission in construing the exemption for insurance companies contained in Section 3 (c) (3) of the Investment Company Act. State insurance commissioners are presumably interested in overseeing any insurance functions being performed by companies within their states and it is not to be expected that they will refuse to accept a proffered submission to their jurisdiction. Particularly in view of the dual regulation contemplated by the federal securities acts, this acceptance of regulation by the state commissioners should have no bearing on the determination

of this Commission or of the federal courts whether a company is within the scope of an Act of Congress requiring regulation for the protection of investors. VALIC in its brief in opposition to the petitions for writs of certiorari (pp. 17–18) states that regulation by this Commission under the Investment Company Act would result "in the *utter destruction* of VALIC" because of (a) a prohibition in Section 18 (f) of the Act against an open-end investment company having outstanding a security of any class which has a priority over any other class in assets or dividends and (b) a prohibition in Section 18 (a) of the Act against a closed-end investment company issuing a debt security unless such security has an asset coverage of 300 percent. Whether or not these sections would "bar" the issuance of VALIC's contracts, as contended, the argument amounts only to the proposition that, because VALIC seeks to solve an economic problem, it must be allowed to operate in a manner that does not comply with the standards Congress has deemed necessary for the protection of the public and investors. If federal regulation of these contracts is comprehended by the federal securities acts, that regulation may of course alter the methods by which the respondents are doing business.[39] Actually, however, the impediments to compliance with the Investment Company Act do not appear as basic as the respond-

[39] By Section 6 (c) of the Act (15 U. S. C. 80a–6 (c)), the Commission is given authority to grant exemptions from any of the provisions of the Investment Company Act on a finding that exemption is "necessary or appropriate in the public interest."

ents imply. The fundamental features which are asserted to characterize variable annuities, that is, payments for the duration of the life of the purchaser which vary in amount to reflect changes in the value of the company's portfolio, do not appear antagonistic to the provisions of the Investment Company Act, even though the respondents would have to alter their structure and the provisions of their present contracts to comply with some of the Act's provisions.

II

THE M'CARRAN-FERGUSON ACT CREATES NO EXEMPTION FROM THE FEDERAL SECURITIES ACTS FOR RESPONDENTS OR FOR THE VARIABLE ANNUITY CONTRACTS WHICH THEY SELL

The respondents and the courts below relied not only on the insurance exemptions in the Securities Act and the Investment Company Act, but also on the McCarran-Ferguson Act (15 U. S. C. 1011–1015), Appendix A, *infra,* pp. 68–69, which was passed by Congress in 1945 to overcome the holding of this Court in *United States* v. *South-Eastern Underwriters Association,* 322 U. S. 533. This Court had held that insurance was commerce and that the antitrust laws were applicable to it. The 1945 statute declared "that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States." 15 U. S. C. 1011, Appendix A, *infra,* p. 68. The explicit provisions of the Act are discussed below.

The basic reason why the McCarran-Ferguson Act has no effect on the federal securities acts in this case is the same which we have discussed in Point I, namely, that the contracts here involved are not insurance and the respondents are not primarily engaged in the insurance business. If the term "business of insurance" in the McCarran-Ferguson Act goes no further than the insurance exemptions of the Securities Act and the Investment Company Act, then its application can have no bearing on the present case; the exemption will exist under all three acts or under none. On the other hand, to construe the term "business of insurance" to have a broader scope than the exemptions in the prior acts would require the assumption that Congress, without giving specific consideration to the legislative purpose of the securities acts or the need of purchasers for the protections afforded thereby, had amended those acts *pro tanto,* a result wholly contrary to the legislative history and purpose of the McCarran Act.

Actually, there is no basis for the assumption that Congress meant by insurance anything different in one statute from the others. All of the arguments which we present above, on the basis of an analysis of the nature of the variable annuity contracts here involved, to show that they are not insurance are equally applicable for the present point. And the possibility of determining the issue on the basis of decisions by individual state insurance commissioners is even more unreasonable, since such an interpretation would result in the provisions of the securities law being inapplicable in some states and applicable

in others."[40] Certainly the federal requirements cannot be said to impinge upon the authority of the insurance authorities in Connecticut, where contracts similar to those here involved have been held not to be insurance, *Spellacy* v. *The American Life Insurance Association*, 144 Conn. 346, *supra*, page 45, merely on the ground that the contrary was held in the District of Columbia by the insurance authorities there.

However, even on the assumption that the respondents are engaged in the "insurance business" within the meaning of that phrase in the McCarran-Ferguson Act, still that Act does not limit the jurisdiction of the Securities and Exchange Commission. As is pointed out above, the purpose of Congress was to counteract the decision of this Court in the *South-Eastern Underwriters* case. To accomplish this end Congress considered that two steps were required.

First, it was necessary to reestablish the States' authority to tax and regulate the business of insurance in spite of the holding that insurance was interstate commerce. This the McCarran Act did by providing that "The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business" and that no act of Congress by its silence or in the absence of specific provision "shall be construed to invalidate, impair, or supersede any

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[40] The Securities Act exemption, Section 3 (a) (8), 15 U. S. C. 77c (a) (8), provides a total country-wide exemption where the insurance is issued by a company licensed by any state authority.

law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business." 15 U. S. C. 1011, 1012. In terms, these provisions were not a limitation on federal regulation; they merely reaffirmed the states' authority to regulate and to tax. They did not eliminate the possibility of dual regulation. This section of the law was construed by this Court in *Prudential Insurance Company* v. *Benjamin,* 328 U. S. 408, and the power of Congress to permit such state regulation of interstate business was affirmed.

The second facet of the McCarran Act was to provide a moratorium upon the imposition of federal authority, the exercise of which had been upheld in the *South-Eastern Underwriters* case. Here, Congress had a choice. It could have suspended the imposition of all federal regulatory powers when applied to insurance or limited the suspension to the class of regulation which had thrown the insurance companies into confusion as a result of the *South-Eastern Underwriters* case. Congress took the latter course and legislated specifically with reference to the Sherman Act, the Clayton Act, the Federal Trade Commission Act, and the Robinson-Patman Act. By 59 Stat. 34, it suspended the application of these laws to insurance until January 1, 1948, and as to the first three it provided that they should apply thereafter only if such business should not then be regulated by state law. In *Maryland Casualty Co.* v. *Cushing,* 347 U. S. 409, this Court had occasion to determine the extent to which federal law had been suspended, the argument being

that because of the McCarran Act the Louisiana insurance law, permitting direct suit against insurers, took precedence over the federal Limited Liability Act, 46 U. S. C. 183. Though there was no opinion for the Court, four of the justices in the majority clearly ruled that the McCarran Act was not to be construed to limit federal regulation beyond the circumstances which led to its enactment. They stated, in an opinion by Mr. Justice Frankfurter, at 413:

> Suffice it to say that even the most cursory reading of the legislative history of this enactment makes it clear that its exclusive purpose was to counteract any adverse effect that this Court's decision in *United States* v. *South-Eastern Underwriters Association,* 322 U. S. 533, might be found to have on State regulation of insurance. * * *
>
> The question whether application of the direct action statute conflicts with federal maritime law is not touched by the *South-Eastern Underwriters* case. In the face of this unequivocal expression of congressional meaning, the statute cannot be read as doing something that Congress has told us it was not intended to do. The McCarran Act is not relevant here.

Although the fifth Justice on the majority, Mr. Justice Clark, did not discuss the application of the McCarran Act, his holding must be construed as indicating that he also did not believe that the Limited Liability Act was altered by the McCarran Act.

The legislative history of the statute fully supports the meaning of its language as so construed. H. Rep. No. 143, 79th Cong., 1st Sess., at page 3 states:

> It is not the intention of Congress in the enactment of this legislation to clothe the States with any power to regulate or tax the business of insurance beyond that which they had been held to possess prior to the decision of the United States Supreme Court in the *Southeastern Underwriters Association* case.

And the same report describes the purpose of the bill as follows:

> The purpose of the bill is twofold: (1) To declare that the continued regulation and taxation by the several States of the business of insurance is in the public interest; and (2) to assure a more adequate regulation of this business in the States by suspending the application of the Sherman and Clayton Acts for approximately two sessions of the State legislatures, so that the States and the Congress may consider legislation during that period. * * *

The only basis on which it could be argued that the McCarran Act wrote an additional exemption into the Securities Act and the Investment Company Act would be by the artificial construction that, insofar as regulation by the Securities and Exchange Commission differs from that of the state insurance commissioner, it would thereby "invalidate, impair, or supersede" the State's insurance laws. But this is not realistic in the light of the specific clauses in both Acts, Section 18 of the Securities Act (15 U. S. C. 77 (r)) and Section 50 of the Investment Company Act

(15 U. S. C. 80a–49), preserving to the state regulatory bodies their jurisdiction. Obviously, the acts are intended by Congress to be complementary, and the securities legislation was not at all intended to invalidate, impair, or supersede the state statutes.

But even if it were asserted on the basis of some unusual construction that somehow the Securities Act and the Investment Company Act did invalidate, impair, or supersede state laws dealing with insurance, still Section 2 of the McCarran Act (15 U. S. C. 1012) saves them since they "specifically relate to the business of insurance." As indicated in the preceding points, there are specific references to insurance in both the Securities Act of 1933 and the Investment Company Act of 1940. Through these references Congress gave expression to the extent to which there might be regulation by the Securities and Exchange Commission over instruments with insurance characteristics and over companies selling such instruments. Thus, Section 3 (a) (8) of the Securities Act, read together with Section 24 (d) of the Investment Company Act, both of which were in effect prior to passage of the McCarran Act, had made it clear that certain insurance policies were not to be exempt from the registration provisions of the Securities Act, *i. e.*, those not subject to the supervision of a state insurance or bank commissioner and those so subject if issued by an investment company. Similarly, Sections 3 (c) (3) and 2 (a) (17) of the Investment Company Act make it clear that a company which is within the definition of an investment company and which is also engaged in the writing of insurance but

not primarily and predominantly so engaged is subject to regulation under the Investment Company Act. See also Section 28 (a) (2). (G) of the Investment Company Act, 15 U. S. C. 80a–28 (a) (2) (G), discussed at page 51, *supra,* and Section 12 (g), 15 U. S. C. 80a–12 (g), which states specifically with respect to restrictions on the purchase of insurance securities by registered investment companies:

> Nothing contained in this section shall in any way affect or derogate from the powers of any insurance commissioner or similar official or agency of the United States or any State * * *.

Presumably, companies selling insurance are generally subject to the regulation of state insurance authorities, whether or not this is their predominant business, just as insurance policies written by an investment company may be under the jurisdiction of state authorities. As we have seen, both state and federal regulation, in certain of these areas, was clearly contemplated by Congress prior to passage of the McCarran Act. This is explicit in Section 18 of the Securities Act and Sections 12 (g) and 50 of the Investment Company Act (see *supra,* pp. 59–60). The McCarran Act, which was enacted to prevent misconstruction of "silence on the part of the Congress", intended no different result.

For the foregoing reasons the judgment of the Court of Appeals should be reversed.

Respectfully submitted.

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DECEMBER 1958.

APPENDIX A

STATUTES INVOLVED

Section 2 (1) of the Securities Act of 1933 (48 Stat. 74, as amended; 15 U. S. C., Sec. 77b (1)) provides:

> SEC. 2. When used in this title, unless the context otherwise requires—
>
> (1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

Section 3 (a) (8) of the Securities Act of 1933 (48 Stat. 74; 15 U. S. C. 77c (a) (8)) provides:

> SEC. 3. (a) Except as hereinafter expressly provided, the provisions of this title shall not apply to any of the following classes of securities.
>
> * * * * *
>
> (8) Any insurance or endowment policy or annuity contract or optional annuity contract, issued by a corporation subject to the supervision of the insurance commissioner, bank commissioner, or any agency or officer performing like functions, of any State or Territory

of the United States or the District of Columbia;

Section 5 of the Securities Act of 1933 (48 Stat. 77; 15 U. S. C., Supp. II, Sec. 77e) provides:

SEC. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

(2) to carry or to cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the reg-

istration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

Section 18 of the Securities Act of 1933 (48 Stat. 85; 15 U. S. C. 77r) provides:

> Nothing in this title shall affect the jurisdiction of the securities commission (or any agency or office performing like functions) of any State or Territory of the United States, or the District of Columbia, over any security or any person.

Section 3 (a) (1) and 3 (a) (3) of the Investment Company Act of 1940 (54 Stat. 797; 15 U. S. C. 80a–3 (a) (1) and (3)) provide:

> SEC. 3. (a) When used in this title, "investment company" means any issuer which—
>
> (1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;
>
> * * * * *
>
> (3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.
>
> * * * * *

Section 3 (c) (3) of the Investment Company Act (54 Stat. 798; 15 U. S. C. 80a–3 (c) (3)) provides:

> (c) Notwithstanding subsections (a) and (b), none of the following persons is an investment company within the meaning of this title:
>
> * * * * *

(3) Any bank or insurance company; * * *

An insurance company is defined in Section 2 (a) (17) of the Investment Company Act (54 Stat. 790, 793; 15 U. S. C. 80a–2 (a) (17)) as—

> (a) When used in this title, unless the context otherwise requires—
>
> * * * * *
>
> (17) "Insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner or a similar official or agency of a State; or any receiver or similar official or any liquidating agent for such a company, in his capacity as such.

Section 12 (g) of the Investment Company Act of 1940 (54 Stat. 810; 15 U. S. C. 80a–12 (g)) provides:

> (g) Notwithstanding the provisions of this section any registered investment company and any company or companies controlled by such registered company may purchase or otherwise acquire from another investment company or any company or companies controlled by such registered company more than 10 per centum of the total outstanding voting stock of any insurance company owned by any such company or companies, or may acquire the securities of any insurance company if the Commission by order determines that such acquisition is in the public interest because the financial condition of such insurance company will be improved as a result of such acquisition or any plan contemplated as a result thereof. This section shall not be deemed to prohibit the promotion of a new insurance company or the acquisition of the securities of any newly created

insurance company by a registered investment company, alone or with other persons. Nothing contained in this section shall in any way affect or derogate from the powers of any insurance commissioner or similar official or agency of the United States or any State, or to affect the right under State law of any insurance company to acquire securities of any other insurance company or insurance companies.

Section 24 (d) of the Investment Company Act of 1940 (54 Stat. 826; 15 U. S. C. 80a–24 (d)) provides:

> (d) The exemption provided by paragraph (8) of section 3 (a) of the Securities Act of 1933 shall not apply to any security of which an investment company is the issuer. The exemption provided by paragraph (11) of said section 3 (a) shall not apply to any security of which a registered investment company is the issuer, except a security sold or disposed of by the issuer or bona fide offered to the public prior to the effective date of this title, and with respect to a security so sold, disposed of, or offered, shall not apply to any new offering thereof on or after the effective date of this title.

Section 50 of the Investment Company Act of 1940 (54 Stat. 846; 15 U. S. C. 80a–49) provides:

> SEC. 50. Except where specific provision is made to the contrary, nothing in this title shall affect (1) the jurisdiction of the Commission under the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, or title II of this Act, over any person, security, or transaction, or (2) the rights, obligations, duties, or liabilities of any person under such Acts; nor shall anything in this title affect the jurisdiction of any other commission, board, agency, or officer of the

United States or of any State or political subdivision of any State, over any person, security, or transaction, insofar as such jurisdiction does not conflict with any provision of this title or of any rule, regulation, or order hereunder.

The McCarran-Ferguson Insurance Regulation Act (15 U. S. C. 1011) provides:

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That the Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.

SEC. 2. (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.

(b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance: *Provided,* That after June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, shall be applicable to the business of insurance to the extent that such business is not regulated by State law.

SEC. 3. (a) Until June 30, 1948, the Act of July 2, 1890, as amended, known as the Sherman Act, and the Act of October 15, 1914, as

amended, known as the Clayton Act, and the Act of September 26, 1914, known as the Federal Trade Commission Act, as amended, and the Act of June 19, 1936, known as the Robinson-Patman Anti-discrimination Act, shall not apply to the business of insurance or to acts in the conduct thereof.

(b) Nothing contained in this Act shall render the said Sherman Act inapplicable to any agreement to boycott, coerce, or intimidate, or act of boycott, coercion, or intimidation.

SEC. 4. Nothing contained in this Act shall be construed to affect in any manner, the application to the business of insurance of the Act of July 5, 1935, as amended, known as the National Labor Relations Act, or the Act of June 25, 1938, as amended, known as the Fair Labor Standards Act of 1938, or the Act of June 5, 1920, known as the Merchant Marine Act, 1920.

SEC. 5. As used in this Act, the term "State" includes the several States, Alaska, Hawaii, Puerto Rico, and the District of Columbia.

SEC. 6. If any provision of this Act, or the application of such provision to any person or circumstances, shall be held invalid, the remainder of the Act, and the application of such provision to persons or circumstances other than those as to which it is held invalid, shall not be affected.

APPENDIX B

Assuming the calculation of the value of an accumulation unit and an annuity unit on February 28:

The formula for an accumulation unit is: Pl. Ex. 3–C (R. 632–3) and 3–D (R. 634).

$$\left[\left(\frac{\text{February}^{1}\ \text{Investment Income} + \text{February Realized and Unrealized Capital Gains}^{1} - \text{February Realized and Unrealized Capital Losses}^{1}}{\text{Value of the Investable Assets at the Beginning of February}^{1}}\right) - .0015^{2} + 1.0000^{3}\right] \times \text{Value of the Accumulation Unit at the Beginning of February} = \text{Value of the Accumulation Unit at the End of February}$$

The formula for an annuity unit is: Pl. Ex. 3–C (R. 632–3) and 3–O (R. 644).

$$\left[\left(\frac{\text{January}^{1}\ \text{Investment Income} + \text{January Realized and Unrealized Capital Gains}^{1} - \text{January Realized and Unrealized Capital Losses}^{1}}{\text{Value of the Investable Assets at the Beginning of January}^{1}}\right) - .0015^{2} + 1.0000^{3}\right] \times .9971^{4} \times \text{Value of the Annuity Unit at the Beginning of February} = \text{Value of the Annuity Unit at the End of February}$$

[1] The terms "Investment Income," "Realized and Unrealized Capital Gains," "Realized and Unrealized Capital Losses," and "Value of the Investable Assets" are not defined in the contract and are subject to differing interpretations by accountants and actuaries (Pl. Ex. 3–C, R. 633). No attempt is made here to further define factors.

[2] This constitutes a charge of approximately 1.8% of the "investable assets" per year. There has been no explanation as to the reason for this charge; however, it appears to be similar to the "management fee" charged by many investment companies.

[3] This factor is added so that the calculation will be expressed as a percentage of the unit value at the beginning of the month.

[4] This figure is a reduction factor which neutralizes the effect of using an annuity table based on an assumed 3.5% interest in order to pass on to the purchaser the risk of variation from the assumed rate of interest. See footnote No. 7, page 7, *supra*.

U. S. GOVERNMENT PRINTING OFFICE: 1958

Reply Brief for the Petitioner

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In the Supreme Court of the United States

OCTOBER TERM, 1958

No. 290

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

VARIABLE ANNUITY LIFE INSURANCE COMPANY OF AMERICA, AND THE EQUITY ANNUITY LIFE INSURANCE COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

REPLY BRIEF FOR THE PETITIONER

The respondents' briefs make it clear that the basic issue in this case is whether the fact that variable annuity contracts provide for the payment of benefits measured by the life span of the purchasers, in and of itself, makes them insurance under the securities laws and the McCarran Act. It does not help the respondents repeatedly to call themselves insurance companies and to assert over and over again that the contracts are insurance. The respondents are insurance companies only if the contracts they sell are insurance and the contracts are insurance only if their

predominant feature is to assume risks of loss which the purchaser would otherwise bear. And, in fact, the contracts are not insurance since, underlying the provision for spreading the payments over the life span of the purchasers, there is the unpredictable feature of measuring the amount of the payments by the success of the management in placing its funds. This basic feature permeates the entire contract and, therefore, underlies this entire case.

We turn now to several of respondents' points which call for further discussion.

1. *It is not the purpose of the Securities and Exchange Commission to outlaw variable annuities.*

VALIC indicates that the variable annuity is a solution culminating four decades of investigation into the problem of inflation (Br. pp. 39–49), and both respondents argue that regulation pursuant to the federal securities acts would destroy this device (EALIC Br. p. 17; VALIC Br. pp. 51–53). As set forth in our main brief (p. 32), this Commission has no authority or desire to interfere with economic experimentation of the sort represented by the variable annuities. It seeks only to prevent evasion of the conditions designed by Congress for the protection of investors. Concededly, some changes in respondents' methods would be required by application to them of the Securities Act and the Investment Company Act. But plans having substantially similar features to those sold by respondents could be drawn in a manner which would not conflict with the provisions of these laws. Moreover, the Commission could invoke the broad exemptive provisions of the Investment Company Act,

to the extent that it might find them "necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions" of that Act. See Section 6(c) of the Investment Company Act, 15 U.S.C. 80a–6.

2. *The essence of the variable annuity is investment, not insurance.*

As indicated in our main brief (pp. 33 *et seq.*), variable annuity holders have no basic insurance protection; the value of their individual shares varies directly with the success or lack of success of the company's investment program, and, should their savings be impaired as a result of unfavorable investments, there will be no obligation on the companies to make up the loss.[1] Respondents concede that investment risk is not an insurable risk (EALIC Br. p. 9; VALIC Br. p. 34). They argue, however, that investment risk is assumed by purchasers of certain types of insurance and apparently would conclude therefrom that the assumption of investment risk by a purchaser of a contract is an invalid test as to whether the company is required to comply with the Securities Act and the Investment Company Act. We do not contend that the purchaser of traditional insurance assumes no investment risk; our contention is that Congress presumably thought that that risk was of such a comparatively minor character, particularly in view of

[1] We note that VALIC (Br. p. 88) equates its policies to a policy with a token mortality guarantee, thereby apparently conceding that they provide no basic insurance protection by way of mortality guarantee.

state regulation, that there was no need to require compliance with the federal securities laws.

It is true that a mutual insurance company or any traditional insurance company writing "participating policies" (referred to in VALIC Br. pp. 36, 43, 93) may distribute dividends in the nature of a return of premium as a result of profitable operations and that these can come about by reason of a favorable investment return, as well as by reason of a favorable mortality experience or lower expenses than anticipated. A mutual policy holder or a holder of the traditional "participating policy", however, like other purchasers of true insurance, is assured of receiving the face amount named in his policy upon the occurrence of the hazard against which he is insured; this is his basic insurance protection. The primary aim of the investment policy of a mutual insurance company, like that of other true insurance companies, is necessarily to provide that there will be sufficient funds to meet its dollar commitments to its policy holders under any circumstances—and Congress presumably felt that supervision by state insurance commissions would prevent deviation therefrom. The investment policy of a variable annuity company, having no such commitment, may be substantially different. Accordingly, variable annuity holders are entitled to have full disclosure of this investment policy;[2] such disclosure

[2] VALIC's argument (Br. p. 38 fn. 4) that the quality and diversification of an insurer's investments are determined by local statutes ignores the wide range of permissible selections. The section (§ 35–535 of the District of Columbia Life Insurance Act) describing permissible investment covers five printed columns in the D. C. Code and includes *inter alia* small loans, mort-

would result from registration of the variable annuity contracts under the Securities Act of 1933 and of the issuing companies under the Investment Company Act of 1940.

Respondents also point to the Immediate Participation Guaranteed Policies (EALIC Br. p. 10; VALIC Br. pp. 24–25) and the College Retirement Equities Fund (EALIC Br. p. 3; VALIC Br. p. 47). These contracts were not in existence when the federal securities acts were enacted (*id.;* R. 539) and hence they can hardly be used as a standard by which to judge whether contracts are exempt from the Securities Act as insurance, or whether a company issuing them is exempt from the Investment Company Act as an insurance company. The line between insurance and investment has been blurred by the inclusion in modern insurance policies of an increasing number of investment characteristics and borderline contracts are difficult to classify. Where, as with the variable annuity contract, however, the dominant characteristic and primary appeal is clearly the investment in securities, the contract is covered by the Securities Act, even where issued by a company subject to regulation by a state insurance commission. In any event, the CREF and IPG plans are distinguishable from those here involved. The IPG contracts are group pension plans which are paid for only by the employer, while

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gage notes, ground rents and equipment trust certificates. The description of equity securities which may be purchased is so broad that it would presumably include the securities of thousands of companies in the United States and Canada.

the employee, who cannot withdraw the funds, is the beneficiary of a *fixed dollar payment* (Tr. 1179). The fact that the employer may pay more or less depending on mortality experience, investment experience, expenses, etc., indicates that this policy, issued presently only to very large groups, is a form of pension plan which is merely administered by an insurance company. The CREF policy on the other hand is closer to the interests here involved, but is issued only in connection with a fixed dollar annuity, and has no surrender rights (R. 483).

VALIC urges (Br. pp. 75, 76) that it is not issuing securities because the District Court made no specific finding that its contract holders were engaged in a "common enterprise"—a term used in this Court's discussion of the test of an investment contract in *S.E.C.* v. *Howey Company,* 328 U.S. 293, 301. The lower court did find that "The distinguishing and predominant nature of a variable annuity is found in its provision for sharing profits and losses in a common fund" (R. 111), and "A VALIC and an EALIC contract holder invests money with the respective defendants with the hope or expectation that a profit will accrue to him as a result of the management of the portfolio of securities purchased by VALIC and EALIC with the money invested by the contract holder, and his expectation of profit based upon the efforts of others applies to both the 'accumulation period' and the repayment or variable annuity period" (R. 109–110). These are descriptions of a common enterprise. At any rate, there can be no doubt but that, under any definition, the investment of funds

for the common benefit of all variable annuity contract holders is a "common enterprise." A single management supervises and directs the investment activities for all the contract holders and each contract holder prospers or suffers in direct proportion to the success or failure of the investment of the group funds. This is the essential characteristic of the variable annuity, and this is the essence of a "common enterprise." It is not affected by the fact that during the pay-out period there will be differences between the interests of individual investors based upon their mortality. There were also differences among the holders of the securities involved in the *Howey* case and in *S.E.C.* v. *Joiner Leasing Corp.*, 320 U.S. 344, to which VALIC also refers.[3]

Respondents point to language in the House Report on the Securities Act (EALIC Br. pp. 22–23; VALIC Br. p. 94) to the effect that "insurance policies are not to be regarded as securities subject to the provisions of the act" since they are not "regarded in the commercial world as securities offered to the public for investment purposes." It is, of course, unnecessary

[3] *Howey* involved a security which consisted of a deed to a specific tract of land together with the offer of a service arrangement under which profits were on an individual basis. As noted by the Court of Appeals in that case, "each purchaser looked for the income from his investment to the fruitage of his own grove and not to the fruitage of the groves as a whole," and individual purchasers were required to pay for replacement of dead trees and other services where required. *S.E.C.* v. *Howey Co.*, 60 F. Supp. 440, 441, affirmed, 151 F. 2d 714, 717 (C.A. 5).

In *Joiner*, each purchaser had an individual leasehold and looked for his profits from expected appreciation therein should a successful well be drilled.

for this Court to determine whether or not traditional insurance policies, which, as we have seen, involve comparatively little investment risk, fall within the definition of Section 2(1) of the Act,[4] since it is clear that the variable annuity contract is an "investment contract" and a "certificate of interest or participation" in a "profit sharing agreement" within the meaning of that definition. See our main brief, pp. 35–38.

EALIC urges (Br. p. 27, and cf. VALIC Br. 96–97) that *S.E.C.* v. *Ralston Purina Co.*, 346 U.S. 119, does not support our statement that the need of a purchaser of a variable annuity for information with which to assess his investment risk is important in determining whether the variable annuity is exempt from registration under the Securities Act. It points out that *Ralston Purina* dealt with Section 4(1) of the Act, "exempt transactions," rather than Section 3 of the Act, which deals with "exempt securities," and which is here involved. But the language we quoted from *Ralston Purina* to the effect that the applicability of an exemption from the Se-

[4] The ambiguous language of the legislative history by no means compels the determination that insurance be excluded from the definition of a security in Section 2(1) of the Act. *Haberman* v. *Equitable Life Assurance Society*, 224 F. 2d 401, 225 F. 2d 837 (C.A. 5), certiorari denied, 350 U.S. 948, cited by respondents (EALIC Br. p. 18; VALIC Br. pp. 78–79) for the proposition that an annuity is not a security, as we noted in our original brief (p. 37, fn. 28), dealt with an ordinary annuity and, moreover, did not involve the federal Securities Act. Similarly, the other cases VALIC cites on this point (Br. p. 79) deal only with annuities with no variable feature and involve state statutes rather than the Securities Act.

curities Act depends on whether the particular class of persons affected needs the protection of the Act (p. 39 of our main brief) in turn quoted from the legislative history of the Act, and that quotation, *i.e.*, "there is no practical need for [the bill's] application," referred not only to exempt transactions but also to exempt securities.[5]

3. *Local insurance codes do not give variable annuity purchasers the protections necessary for investors.*

As pointed out in our main brief (p. 44), the determination of whether a contract is exempt under Section 3(a) of the Securities Act or whether a company is not an investment company by reason of its being primarily an insurance company within the meaning of Section 2(a)(17) of the Investment Company Act is not made dependent upon the decision of local authorities.[6] Nor would the fact that a particular local jurisdiction might have protections analogous to those of the federal securities acts be determinative. We note, nevertheless, that the re-

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[5] The House Report, from which the *Ralston Purina* opinion quotes, states: "[The bill] carefully exempts from its application *certain types of securities* and securities transactions where there is no practical need for its application or where the public benefits are too remote." H.R. Rep. No. 85, 73d Cong., 1st Sess., 5. (Emphasis supplied.)

[6] The *Union Guarantee and Mortgage Company* case, 75 F. 2d 984 (C.A. 2d), certiorari denied, 296 U.S. 594, cited by EALIC (Br. p. 26) for the proposition that Congress "delegated to the states the power to define 'insurance' and 'annuity'" has no application here. It deals with Section 77B of the Bankruptcy Act.

spondents point to no such local regulation. They cite at length the powers granted to the District of Columbia Superintendent of Insurance (EALIC Br. pp. 33–37; VALIC Br. pp. 58–64), but these differ widely from the disclosure and liability provisions of the Securities Act and the detailed protection against insider profits and inequitable practices of the Investment Company Act.

The District of Columbia Life Insurance Act illustrates that local regulation of insurance is patently not adapted to regulation of the investment aspects of the variable annuity. The sale of investment contracts or other securities is prohibited thereunder in connection with the sale of an insurance policy (Section 35–713), and, accordingly, the sweep of its protections does not extend to those necessary for persons who are primarily purchasing units in a portfolio of common stocks. The disclosure standards referred to by respondents, for example (EALIC Br. p. 35; VALIC Br. p. 59), contain no requirement for the delivery to variable annuity purchasers of a prospectus containing detailed specified information considered necessary for investors, as required by Sections 5(b)(2) and 10 of the Securities Act, 15 U.S.C. 77e(b)(2) and 77j. Nor do the requirements of the District of Columbia insurance code meet the situations where the "national public interest and the interest of investors are adversely affected," that are enumerated in Section 1(b) of the Investment Company Act, 15 U.S.C. 80a–1(b), and toward the mitigation and, so far as possible, the elimination of which all provisions of that

Act are to be interpreted. There is no equivalent of the requirements, *inter alia,* of Section 8 of that Act, 15 U.S.C. 80a–8, for the adoption of fundamental investment policies nor of Section 10, 15 U.S.C. 80a–10, for independent directors. See our main brief, pp. 27–29. Respondents point out that the District of Columbia Superintendent of Insurance may revoke the authority of a company to do business where there is impairment of the capital or surplus and may take possession of the company's property where there is insolvency (EALIC Br. p. 36, VALIC Br. p. 63). These provisions are clearly designed to protect policy holders in a true insurance company by assuring that they will receive the sums they contracted for upon the happening of the contingency against which they are insured. As we have noted, however, substantially all of the savings of a holder of a variable annuity could be dissipated without there being insolvency or possibly any serious impairment of capital or surplus.

4. *The respondents are essentially similar to mutual funds.*

Respondents argue (EALIC Br. p. 14, VALIC Br. p. 15) that the "accumulation units" and "annuity units" do not represent an aliquot share or interest in a fund of securities, despite the findings of the District Court to that effect. Findings of Fact 46, 70; R. 107, 109. Whatever semantic distinction they seek to draw from the situation with respect to a mutual fund, it is clear that each holder of either respondent's accumulation units, like an investor in a mutual fund, is entitled at any time to the value

of a portion of its portfolio which is mathematically computable and which varies directly with the investment experience of the portfolio. Stated more precisely, with respect to either respondent at any given time there can be computed the dollar value of that part of its portfolio which is applicable to the accumulation units and each accumulation unit represents an aliquot portion of that figure; *i.e.*, by dividing that figure by the number of accumulation units, the value of each unit can be computed just as the value of an investment company's share can be computed (R. 725). Respondents' argument that there is no aliquot share is based upon the fact that the overall portfolio of each respondent combines the fund applicable to accumulation units with a fund out of which annuity units are to be paid and which includes sums representing capital and surplus.[1] But even after maturity, the amount received each month by contract holders (*i.e.*, the value of their annuity units) is mathematically determinable and varies directly with the investment experience of the portfolio. See Appendix B to our main brief.

[1] These sums necessarily vary in value not only in accordance with the investment experience of the portfolio, but also in accordance with other factors—*i.e.*, the degree that the actual mortality differs from that anticipated, the annual 1.8% charge, and the amount of dividends to stockholders or additional contributions to capital.

VALIC (Br. pp. 16–18) points to the structure of United Funds, Inc., which was set up to comply with the requirements of the Investment Company Act and contrasts it with its own. In our main brief (p. 31–32), we had referred to this company as one of "numerous open-end investment companies, whose shares represent interests similar to the respondents' accumulation units and whose methods of valuation of these shares is basically the same as the method followed by respondents in valuing the units they sell." We had noted that United Funds, Inc., also sold insurance in connection with its plan and had pointed out that in some states and the District of Columbia its salesmen were required to be licensed as insurance salesmen. VALIC's discussion and chart of the United Funds organization, when analyzed, highlights the similarity of United Funds to VALIC. VALIC, so far as the accumulation period of its contracts is concerned, merely combines the functions of underwriter, fund, and manager in a single organization. For example, VALIC, instead of the underwriter, sells, deducts commissions or sales expenses, and remits the net proceeds for the purchase of interests in its portfolio which are equivalent to shares of United Funds. Instead of the Fund paying 0.5% per year to the investment manager (VALIC) (R. 17),

the VALIC management annually charges 1.8% per year. Like the investment manager and underwriter of United Funds, VALIC's management, as underwriter and manager of its portfolio, receives its sales load and the 1.8% charge, no matter whether the portfolio appreciates or depreciates in value.

VALIC indicates (Br. p. 20) that it is impossible to compare its sales load with that of investment companies because the sales load of investment companies "pays none of the investment trust's operating expenses." This is not accurate. The figures VALIC uses in its brief (pp. 19–20) show that, if VALIC were to sell a contract for an aggregate of premiums totaling $30,000, this would produce a net investment of $26,745. Its sales load (charges other than for life insurance benefits) would be $600 for taxes and $2,550 for other purposes, totaling $3,150 or 10.5% of the gross investment. On the other hand, if United Funds were to sell a contract grossing $30,000, it would only be allowed to charge 9% thereof,[a] or $2,700,[b] thereby producing a greater net investment. It is true that United Funds would make an additional charge of approximately 0.5% per year (VALIC Br. p. 17) to pay the operating expenses of the fund. But

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[a] Section 27 of the Investment Company Act, 15 U.S.C. 80a–27.

[b] United Funds' actual sales charge is 38% for the first year and 1% thereafter (R. 340–341). This would equal on the plans sold by the United Funds 5.625%. Compare this with VALIC's 52% the first year and the percentages decreasing from 12 to 8 in the later years. (See our main brief, p. 4, fn. 3.)

this makes the comparison above no less valid, since VALIC makes a comparable charge of 1.8% per year.[10]

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[10] The respondents' charges of misstatements in our main brief are unjustified. EALIC (Br. p. 11) contends that we have misstated the case with respect to Advisers Fund, Inc., in asserting that purchasers of its periodic payment plans would obtain an annuity at maturity based upon a mortality table guaranteed at the inception of the plan (Br. p. 32); it is pointed out that the insurance company there involved "reserves the right to withdraw the offer or modify the rates or other terms of the commitment * * *" But this is only in connection with the sale of future shares. The balance of the sentence from which VALIC quotes demonstrates that reservation of the right to withdraw is "with respect only to the proceeds from liquidation of shares acquired subsequent to due written notice sent to the affected stockholders * * *" (R. 808)

VALIC's unsupported charge (Br. p. 91) that we misstate the facts and holdings of *Coastal States Life Insurance Company* v. *Kelly* (Court of Common Pleas, Richland County, So. Car., June 1955, unreported) is completely baseless. So is its charge (Br. p. 37) that we erred in summarizing the testimony of the expert witness to the effect that the variable annuity cannot insure against investment risk; indeed, we footnoted the exact statement of the witness. See our brief, p. 35, fn. 26.

Despite a reference to "numerous errors in the SEC Brief" (VALIC Br. p. 37, fn. 2), these are the only specific charges of errors made by VALIC except for a contention (Br. p. 68) that we improperly represented that Section 18 of the Securities Act, 15 U.S.C. 77r, and Section 50 of the Investment Company Act, 15 U.S.C. 80a–49, permit regulation of respondents by state regulatory commissions as well as by this Commission. While it is true that Section 18 of the Securities Act refers specifically to state securities commissions, Section 50 of the Investment Company Act provides that nothing therein shall "affect the jurisdiction of any other commission, board, agency, or officer of the United States or of any State or political subdivision of any State, over any person, security, or transaction, insofar as such jurisdiction does not conflict with any provision * * *" of that Act or rule, regulation, or order thereunder. It is clearly not limited merely to state securities commissions.

CONCLUSION

For the reasons stated in our main brief and in this reply brief, we believe the judgment of the court below should be reversed.

Respectfully submitted.

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JANUARY 1959.

U. S. GOVERNMENT PRINTING OFFICE: 1959